

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **201228014**
Release Date: 7/13/2012

Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact:

Index Number: 1381.02-00

, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B05
PLR-141816-11
Date:
March 28, 2012

Legend

Taxpayer =

State A =

Corp A =

Corp B =

Corp C =

Corp D =

E =

Dear :

This is in response to a request for a ruling dated September 30, 2011, submitted on behalf of Taxpayer by your authorized representative. The ruling concerns the application of cooperative tax law to a transaction described below.

Taxpayer was incorporated in pursuant to the State A Administrative Code. Taxpayer is a rural telephone company operated on a cooperative, non-profit basis for the mutual benefit of its members. It serves members/patrons northwestern State A.

According to Taxpayer's Amended Articles of Incorporation dated

:

"[t]he purposes for which said corporation is formed are building, purchasing, and otherwise acquiring, equipping, maintaining, and operating telephone and broadband systems and furnishing telephone and broadband service or either in [Taxpayer] and neighboring townships, villages, and communities for the mutual benefit of its members, and doing any and all things necessary or incident thereto."

The "Code of Regulations of the [Taxpayer]" (i.e., "the Bylaws") prescribe the rights and responsibilities of the Taxpayer and its members.

Article I. Requirement for Membership, Section 1 states that "any person, firm, association, Company, limited liability company, limited liability partnership, or body politic, or subdivision thereof may become a member of the [Taxpayer], hereinafter called the Company" by complying with rules typical of cooperative organizations.

Article II. Rights and Liabilities of the Company and the Members, Section 3 "*Property Interest of Members*" states the following:

"Upon dissolution after (a) all debts and liabilities of the Company have been paid, (b) all capital furnished through patronage shall have been retired as provided in this code of regulation, and (c) the membership fees shall have been repaid, the remaining property and assets of the Company shall be distributed among members in proportion which the aggregate bears to the total patronage of such members and former members on the date of dissolution, unless otherwise provided by law."

Article III. Meeting of Members, Section 7, *Voting at Meetings*, states in part that:

"Each member shall be entitled to only one vote upon each matter submitted at a meeting of the members."

Article IV. Trustees, Section 1, *General Powers*, states that:

"The business and affairs of the Company shall be managed by a board of trustees which shall exercise all powers of the Company except as are by law, Article of incorporation or this code of regulation conferred upon or reserved to the members."

Section 2, *Election and Tenure of Office*, states in part that:

“The trustees shall be elected by secret ballot at the annual meeting of the members by and from the members to serve until their successors shall have been elected and qualified.”

Article VIII. Non-Profit Operation, describes the manner in which the Taxpayer will operate with respect to its members.

Section 1, *Interest or Dividends on Capital Prohibited*, states:

“The Company shall at all times be operated on a mutual non-profit basis for the mutual benefit of its patrons. No interest or dividends shall be paid or payable by the Company on any capital furnished by its patrons.”

Section 2, *Patronage Capital in Connection with Furnishing Telecommunications, Communications, Telephone and Information Services* obligates its members/patrons to furnish and the Taxpayer to account for on a cooperative basis to all its patrons “for all amounts received and receivable from the furnishing of telecommunications, communications and information services in excess of operative costs and expenses properly chargeable against furnishing services.”

Taxpayer received tax exemption from the Service on _____, for telephone and broadband services under section 501(c)(12)(A) of the Internal Revenue Code. As telephone business has changed, fewer rural telephone cooperatives have been able to satisfy the 85 percent income test prescribed by section 501(c)(12)(A). Taxpayer believes it will not pass the 85 percent test for either tax years 2011 or 2012.

In early 1980, American Telephone & Telegraph (AT&T) advised the independent telephone industry of the prospective availability of a new telephone service to subscribers. AT&T’s new system was known as a Data Base Administration System (DBAS) and it enabled its customers to use the then recently developed Calling Card Service (CSS), also known as Auto Bill Calling service (ABC). With that service, the Taxpayer’s member/patrons would be able to make credit available, collect, or third-party long distance calls with the assistance of an operator.

While AT&T offered this service to the over 1,100 independent telephone companies (including many rural telephone cooperatives like Taxpayer), the necessary capital expenditure for each to participate would be prohibitive. At the same time it was clear to small companies that they needed to offer the same type of services to their subscribers enjoyed by customers of larger telephone companies. Therefore, the smallest of the telephone companies formed Corp A allowing participation in the AT&T system. Corp A followed many of the same principles as cooperatives such as

governance by one-voter per member and distribution of margins based on member participation.

In _____, Taxpayer purchased 1 share of Class A Voting Stock and _____ shares of Class B Non-voting Stock in Corp A. As part of the stock purchase, Taxpayer agreed to use the services of Corp A's Mechanized Calling Card Services data utilizing a DBAS according to specifications of AT&T.

In _____, Taxpayer signed Corp A's "800 Services" – "Independent Responsible Organization Agreement."

In _____, Taxpayer signed Corp A's AT&T "Communications Standard Agreement" for the provision of telecommunications services and facilities.

In _____, Taxpayer purchased an additional share of Class A Voting Stock and _____ Shares of Class B Non-Voting Stock in Corp A.

In _____, Taxpayer signed Corp A/Local Exchange Carrier (LEC) Agreement for Other Service Provider (OSP) billing and collection services.

In _____, Taxpayer signed a variety of Corp A's Master Service Agreements which brought in MCI and Sprint service process.

In _____ Taxpayer paid \$ _____ for Preferred Stock and Convertible Debentures in Corp B, a new corporation formed by Corp A. Corp B was formed to operate and manage a new and powerful "SS7" network to allow Taxpayer to meet its members/patrons need for enhanced information services.

In _____, it was announced that Corp B and Corp A were merging to become Corp C. Taxpayer's Corp B and Corp A stock certificates were replaced by stock certificates of Corp C.

In _____, Corp C became a wholly-owned subsidiary of Corp D. That transaction was followed by Taxpayer exchanging Holding Common Stock for _____ shares of Corp D Common Stock.

In _____, Taxpayer received a letter from Corp D announcing that it had sold their Communications Services Group Business to E. The last receipt for purchased services made by Taxpayer from Corp D was received in _____.

Because Corp D no longer provides Taxpayer with service, the Board of Trustees has decided to sell all of the Corp D stock in various tranches and redeploy proceeds of that sale to current telecommunications construction projects necessary to serve its

members/patrons. The capital gain realized on the sale will be allocated based on historic records maintained by Taxpayer on its member/patron service.

Based on the foregoing, Taxpayer request a ruling that:

The capital gain realized by the Taxpayer from the sale of Corp D stock constitutes “patronage-sourced” income which if properly allocated to its members/patrons will be excludable from gross income as a true patronage dividend.

In the event a rural telephone cooperative such as Taxpayer loses its tax-exempt status, section 501(c)(12) of the Code no longer applies until such time as the cooperative again satisfies the requirements for exemption. During any taxable period, the rules applicable to the telephone cooperative depend on the reasons why it failed its exemption tests. If exemption was lost because the company failed to operate on a cooperative basis, then it will be taxed under the same rules applicable to for-profit corporations. Alternatively, if the cooperative becomes taxable because it failed the so-called 85 percent income test imposed by section 501(c)(12), then the organization will be taxed as a cooperative.

While the requirements of subchapter C of the Code regarding corporate distributions and adjustments and other provisions are generally applicable to nonexempt cooperatives, these entities are distinguished from other types of corporations by a specific body of tax law. The scheme of taxation for nonexempt cooperatives was developed from the administrative pronouncements of the Service and decision of the judiciary over a fifty-year period. These rules for tax treatment of most nonexempt cooperatives and their patrons were finally codified with the enactment subchapter T as part of the Revenue Act of 1962. Pub. L. No. 87-834 (H.R. 10650).

With passage of subchapter T of the Code, the rules for deduction of patronage dividends and the treatment of patronage dividends in the hands of a cooperative’s patrons were defined. However, section 1381(a)(2)(c) states that subchapter T is not applicable to organization engaged in furnishing electric energy, or providing telephone service to persons in rural areas. According to the Senate Finance Committee Report accompanying the 1962 Act, the intent of Congress was that nonexempt rural electric and telephone cooperatives would continue to be treated as under “present law.”

In its report accompanying the legislation, the Senate Finance Committee described “present law” as follows:

“Under present law patronage dividends paid by taxable cooperatives result in a reduction in the cooperative’s taxable income only if they are paid during the taxable year in which the patronage occurred or within the period in the next year elapsing before the prior year’s income tax return is

required to be filed (including any extensions of time granted).” S. Rep. No. 1881, 87th Cong., 1st Sess. 113 (1962).

Under this earlier body of tax law applicable to nonexempt telephone cooperatives, a cooperative may reduce its taxable income by any qualifying patronage dividends paid to their members/patrons. Further, under pre-1962 cooperative rules, the term “paid” means paid in cash or paid by notice of allocation. See also Rev. Rul. 83-135, 1983-2 C.B. 149 (A taxable cooperative not subject to the provisions of subchapter T of the Code may exclude from gross income the patronage dividends paid or allocated to its patrons in accordance with its by-laws).

While subchapter T of the Code does not control the taxation of nonexempt telephone cooperatives, its foundations rest upon pre-1962 cooperative tax law. As a result, there are certain basic parallels between the tax treatment of nonexempt utility cooperatives and treatment of other cooperative organizations under subchapter T. Therefore, to extent that subchapter T reflects cooperative taxation as it existed prior to 1962, it is instructive resolving certain issues facing rural telephone cooperatives. This is because Congress stated that in enacting subchapter T it was merely codifying the long common law history of cooperative taxation (with the exception of ensuring at least one annual level of tax at the cooperative or patron level. See S. Rep. No. 1881, 87th Cong., 1st Sess. 113 (1962)) and, arguably, the case law post-enactment is merely a continuation and refinement of the pre-enactment common law. This is particularly true with respect to defining certain terms such as “operating on a cooperative basis” and “patronage income.”

Perhaps the most succinct definition of the term “cooperative” for Federal income tax purposes was provided by the U.S. Tax Court in *Puget Sound Plywood, Inc. v. Commissioner*, 44 T.C. 305 (1965), *acq.* 1966-1 C.B. 3. The Tax Court said:

“Under the cooperative association form or organization, on the other hand, the worker-members of the association supply their own capital at their own risk; select their own management and supply their own direction for the enterprise, through worker meetings conducted on a democratic basis; and then themselves receive the fruits of their cooperative endeavors, through allocations of the same among themselves as co-workers, in proportion to the amounts of their active participation in the cooperative undertaking.”

The Tax Court went on to describe three guiding principles at the core of economic cooperative theory as:

“(1) Subordination of capital, both as regards control over the cooperative undertaking, and as regards the ownership of the pecuniary benefits

arising therefrom; (2) democratic control by the worker-members themselves; and (3) the vesting in and allocation among the worker-members of all fruits and increases arising from their cooperative endeavor (i.e., the excess of operating revenues over the costs incurred in generating those revenues), in proportion to the worker-members' active participation in the cooperative endeavor." 44 T.C. at 308.

The mechanism by which telephone cooperative achieve operation at cost is the patronage dividend (or capital credit). Since the payment of patronage dividends (and operation at cost) is so critical to achieving cooperative status as defined by *Puget Sound*, it is important to analyze this issue.

Rural telephone cooperatives perform a final accounting at year-end to determine the net margin derived from their members' patronage during the course of the year. Then, the excess over cost collected from members is returned to them by a capital credit allocation based on each member's patronage. Those capital credits are typically "paid" by allocations of capital credit certificates or notices of allocation, rather than in cash. The capital credits retained form the foundation for the organization's equity capital.

A true patronage dividend that may be excluded from the income of a rural telephone cooperative must meet the three tests set forth in *Farmers Cooperative Co. v. Birmingham*, 86 F. Supp 201 (N.D. Ia. 1949), and *Pomeroy Cooperative Grain Co. v. Commissioner*, 31 T.C. 674 (1958), *acq.*, AOD 1959-2 C.B. 6. Those tests are:

1. It must be made subject to a preexisting legal obligation;
2. the allocation must be made on the basis of patronage; and
3. the margins allocated must be derived from the profits generated from patrons' dealings with the cooperative.

Although the Code does not provide specific guidance as to what constitutes patronage-sourced income for a nonexempt telephone cooperative, regulations and rulings address the issues for cooperatives governed by subchapter T of the Code. While not directly applicable to taxable utility cooperatives per se, arguably they reflect the correct analysis with respect patronage income of cooperatives subject to pre-1962 law.

The Senate Committee Report accompanying the cooperative provisions in the Revenue Act of 1951 indicated that the Congress intended to tax "ordinary" (i.e., non-farmer) cooperatives for:

“non-operating income...not derived from patronage, as for example in the case of interest or rental income, even if distributed to patrons on a pro rata basis.” S. Rep. No. 781, 82d Cong. 1st Sess. (1951).

In response to that guidance of Congress, the Service promulgated regulations distinguishing nonpatronage income from that which is patronage derived.

Section 1388(a)(3) of the Code specifies that a patronage dividend must be “determined by reference to the net earnings of the organization from business done with or for its patrons.” That section further provides that the term “patronage dividend” does not include any amount paid to a patron to the extent that such amount is out earnings other than from business done with or for patrons. Further, it does not include earnings from business done with or for other customers “to whom no amounts are paid, or to whom smaller amounts are paid with respect to substantially identical transactions.”

In Rev. Rul. 69-576, 1969-2 C.B. 166, a nonexempt farmers’ cooperative borrowed money from a bank for cooperatives (itself a cooperative) to finance the acquisition of agricultural supplies for resale to its members. The bank for cooperatives allocated and paid interest from its net earnings to the nonexempt farmers’ cooperative which it in turn allocated to its members.

In determining whether the allocation was from patronage sources the ruling states:

The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources. Rev. Rul. 69-576 at 167.

The ruling concluded that in as much as the income received by the nonexempt cooperative from the bank for cooperatives resulted from a transaction that financed the acquisition of agricultural supplies which were sold to its members, thereby directly facilitating the accomplishment of the cooperative’s marketing, purchasing, or service activities, the income was patronage sourced.

Section 1.1382-3(c)(2) of the Income Tax Regulations defines income from sources other than patronage (nonpatronage income) to mean incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association such as income derived from lease of premises, from investment in securities, or from the sale or exchange of capital assets.

In *St. Louis Bank for Cooperatives v. United States*, 224 Ct. Cl. 289, 624 F.2d 1041 (Cl. Ct. 1980), the Court held that interest on demand deposits in farm credit banks or on loans to brokerage funds received by St. Louis Bank for Cooperatives was patronage sourced income. The Court stated that a particular item of income is patronage sourced when the transactions involved are directly related to the marketing, purchasing, or service activities of the cooperative association. 624 F.2d at 1045.

In *Twin County Grocers, Inc. v. United States*, 2 Cl. Ct. 657 (1983), a nonexempt cooperative was denied deductions for patronage dividends for interest on a certificate of deposit bought from a nonpatron bank because the dividend income was not patronage sourced. The Court held that the relation of income activity to the cooperative's business was too tenuous.

Courts have ruled in several instances that income from corporations organized by cooperatives to conduct activities related to the cooperative business is patronage sourced. In *Farmland Industries, Inc. v. Commissioner*, 78 T.C.M. 846, 864 (1999), *acq.*, AOD 2001-03 (citing *Cotter & Co. v. United States*, 765 F.2d 1102, 1106 (1985); *Land O'Lakes, Inc. v. United States*, 675 F.2d 988, 993 (8th Cir. 1982); *Certified Grocers of Cal., Ltd. v. Commissioner*, 88 T.C. 238, 243 (1987); *Illinois Grain Corp. v. Commissioner*, 87 T.C. 435, 459 (1986)), the taxpayer, a cooperative organized for the purpose of providing petroleum products to its patrons, sought to have the proceeds from the disposition of its stock in three subsidiaries classified as patronage-sourced income. In reaching its decision, the Court stated that its task was to "determine whether each of the gains and losses at issue was realized in a transaction that was directly related to the cooperative enterprise, or in one which generated incidental income that contributed to the overall profitability of the cooperative but did not actually facilitate the accomplishment of the cooperative's marketing, purchasing, or servicing activities on behalf of its patrons." 78 T.C.M. at 870.

In *Land O'Lakes, Inc., supra.*, the Court held that dividends received by the nonexempt cooperative from the St. Paul Bank for Cooperatives was patronage derived and could be allocated to Land O'Lakes patrons as deductible patronage dividends. The court noted that the taxpayer was required to acquire and hold the stock to obtain a loan, the proceeds of which were used to finance cooperative activities on favorable terms finding that the subject transaction was not significantly distinguishable from the transaction in Rev. Rul. 69-576.

In the present case, Taxpayer purchased the stock which ultimately became Corp D stock for the express purpose of gaining telecommunications services for its members/patrons. Taxpayer had no choice but to participate in this way in order to secure these services as it was too small to meet AT&T's requirements to participate. All of its transactions with Corp A, Corp B, Corp C, and Corp D were conducted to obtain vital services for its member patrons. That continued for 20 years until Corp D sold the unit rendering services to an unrelated party. All of Taxpayer's relations with the ever-changing service providers were conducted exclusively for the benefit of Taxpayer's members/patrons. Further, Taxpayer's sale of the stock at issue is not being done to merely enhance profitability but to provide capital for current telecommunications construction projects necessary to serve its members/patrons.

Accordingly, based solely on the foregoing we rule that:

The capital gain realized by the Taxpayer from the sale of Corp D stock constitutes "patronage-sourced" income which if properly allocated to its members/patrons will be excludable from gross income as a true patronage dividend.

This ruling is directed only to the taxpayer that requested it. Under section 6110(k)(3) of the Code it may not be used or cited as precedent. In accordance with a power of attorney filed with the request, a copy of the ruling is being sent to your authorized representative.

Sincerely yours,

/s/ Paul F. Handleman

Paul F. Handleman
Chief, Branch 5
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

cc: